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2014 Mexico's Tax and Social Security Reform

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Report Highlights:
On September 8, 2013, Mexican President Enrique Peña Nieto submitted his tax overhaul proposal for congressional consideration. On October 31, 2013, after intense negotiations, legislative process for a new tax reform ended with its approval by the two chambers of the Mexican Congress. The goals of the tax reform are to strengthen the capacity of the Mexican state to better respond to the needs of the population, and to enhance the country's macroeconomic stability. The Government of Mexico (GOM) intends to meet these goals by restructuring the Mexican tax system and broadening the country's tax base through deep changes to both direct taxes and consumption taxes.

Source: NAFTA works

General Information:

This report aims to explain Mexico's recent fiscal reforms and any possible impact it may have on U.S. food and agricultural exports. Given the breadth of the reform, exporters should clarify with importers and distributors whether their products will be affected, and if so, how.

Compared to 2012, in 2013, a complicated economic and financial outlook prevailed both in Mexico and internationally. On a global scale, economic activity decreased across industrialized and emerging countries. In 2013, the International Monetary Fund (IMF) lowered its expectations for world growth from 3.6 to 3.1 percent, and lowered growth expectations for most large economies including China, Brazil, Russia, South Africa, the United States, and the European Union. On the other hand, international financial markets showed increased volatility beginning in May 2013 as a result of an increasing probability that the United States would stop using financial mechanisms to support economic growth. This trend of increasing volatility and uncertainty caused some capital flow to revert from emerging to advanced economies due to the expectation of rising interest rates in the United States. Some consequences already include the devaluation of some emerging market currencies and an increase in long term interest rates, which could slow or reverse economic recovery in certain regions of the world.

According to the Mexican congress, as a result of the global and domestic economic situation, without reform Mexico's tax collection in 2014 would have stagnated with income and expenditures significantly lower than in 2013, Mexican tax revenues would have decreased by an estimated $147 Billion MX Pesos, about $11.5 Billion USD. Therefore, along with the economic package for 2014, Mexican President Peña Nieto presented a Social and Tax reform aimed at strengthening tax collection for all three government branch and to increase infrastructure and social security investment, in line with the "Pact for Mexico".

The GOM expects that the Social and Tax Reform will increase tax revenue by approximately 3 percent of GDP, although the full effect will not be seen in just one fiscal year. In this case as with prior tax reforms, it will take time for both the authorities and tax payers to fully adapt.

Courtesy Translation: *2014 Economic policy – General Criteria*

TAX REFORM HIGHLIGHTS

The Social and Tax Reform has several components worth mentioning:

1. The health related tax
2. Continuing zero percent tax to food[(1)] and medicines
3. Harmonization of VAT (Value Added Tax) in all of Mexico
4. Elimination of special treatment and preferential tax regimes
5. Establishment of limits on personal tax exceptions and deductions
6. Tax on stock and capital profits
7. Elimination of IETU (Special Tax on Production and Services), IDE (Cash Deposit Tax) and new ISR (Revenue Tax) law
8. Changes to the customs regulation

Before an in-depth review of the Tax Reform we would like to present you with an acronym summary which includes tax-related and explanations of GOM agencies, additionally, you will see a second chart that includes the status of certain taxes in 2014 compared to 2013.

[(1)] Tax exempt food products **exclude**: Junk food (processed products or with any kind of sugar added that result with over 275 calories on every 100 grams). *See list of tax exempt food products on page 10 on this document*

TABLE 1. Acronym list and definitions related to the 2014 Mexican Social and Tax Reform

ACRONYM	DEFINITION
SHCP (Mexican Government entity)	**Secretariat of Finance and Public Credit** Secretaria de Hacienda y Credito Publico - Counterpart of U.S. Treasury Mission: To propose, direct, and control the Federal Government's economic policies on finances, taxes, budget, income, public debt, statistics, and geography and information, in order to consolidate a country with a qualitative, fair, inclusive and sustainable economic growth that can strengthen all Mexicans' well-being.
SAT (Mexican Government entity)	**Tributary Administration Service** Servicio de Administracion Tributaria - Counterpart of U.S. Internal Revenue Service
DOF (Official Publication)	**Official Gazette** Diario Oficial de la Federacion – Counterpart of the U.S. Federal Register All Mexican government rulings and dispositions become official when they are published at the DOF.
RFC (Tax ID)	**Federal Tax Payer Registry** Registro Federal de Causantes - Only Mexican citizens/companies can have it, and those who have it are entitled to get electronic notifications from the Customs "Single Window" system that notifies shipment status electronically.
VU (Customs System)	**Single Window** Ventanilla Unica - It is a tool that allows you to send electronic information only once to a single entity to comply with all requirements of foreign trade. This is possible through the simplification, standardization, and automation of business processes. In practical terms, the main objective of the "Ventanilla Única" is to facilitate and simplify information flows between businesses and government and provide significant benefits to all participants involved in cross-border trade.
IVA (Tax)	**Value Added Tax** Indirect tax applicable to goods and services, which is ultimately paid for by the end consumer; some taxpayers may recover IVA tax in their tax returns based on provision that apply to their particular professional activity, given that they also meet certain requirements
IEPS (Tax)	**Special Tax on Production and Services** Applicable to specialty products such as gasoline, alcohol, tobacco, pet food, junk food among others, it also includes: **Green Taxes for fossil fuels** Established under the premise that: "If you pollute, you pay", this tax applies to sale and import.
ISR (Tax)	**Revenue Tax** Applicable to individuals as well as corporations
IETU (Tax)	**Corporate Flat Rate Tax** Applicable to corporate income, not to consumers
IDE (Tax)	**Cash Deposit Tax** Made to bank accounts of individuals or corporations

Source: *SHCP's official website*
Source: *IVA definition*
Source: *ISR definition*
Source: *SAT's Tax Payer ID*
Source: *SAT´s official web page*
Source: *IETU definition*
Source: *IDE definition*
Source: *SAT's Single Window (English language site)*
Source: *DOF´s official website*
Source: *IEPS definition*
Source: *Tax Reform*

Note: *Mexico´s Fiscal Year is same as the calendar year (January – December)*

Continuing with the Social and Tax Reform review, please find below a description of the highlighted topics, which include the basis for tax determination.

1. THE HEALTH RELATED TAX

This aspect of Mexico's tax reform will likely have the largest impact on U.S. exports. Any product that has more than 275 calories per 100 grams, whether imported or produced domestically, will be subject to an 8 percent "junk food" tax. Exceptions to this tax are listed on page 10 of this report.

Reasons behind this portion of the tax reform:
The Social and Tax Reform creates taxes that will discourage consumption of products that the GOM says are detrimental to human health. This reform aims to diminish the prevalence of obesity in the population and to reduce healthcare costs related to the above mentioned health conditions, while at the same time increasing tax collection.

Being overweight or obese increases the risk of suffering from diseases such as diabetes and hypertension. The GOM says that the magnitude and growth rate of obesity-related diseases currently represents a health emergency in Mexico. Mexico has the second-highest rate of obesity in the Organization for Economic Cooperation and Development (OECD), with 30 percent of the adult population being obese, while the average for OECD member countries is 22.2 percent. The United States is the only country with a higher adult obesity rate than Mexico.

The prevalence of childhood obesity in Mexico shows that stronger measures should be taken to avoid worsening health problems in the future. Mexico has the eighth place in childhood obesity among boys with a 28.1 percent, and the fourth place for girls with a 29 percent. OECD member countries have average obesity rates of 22.4 percent for boys and 22.4 for girls. Additionally, OECD data indicates that in 2010, Mexico had the largest diabetic population with 13 percent, or more than 10 million of the 83 million people suffering from diabetes among member countries.

CHART 1. Prevalence of obesity in adult population

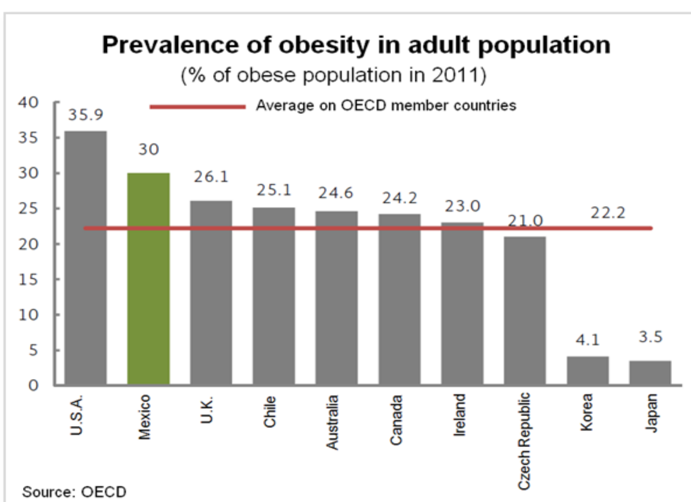
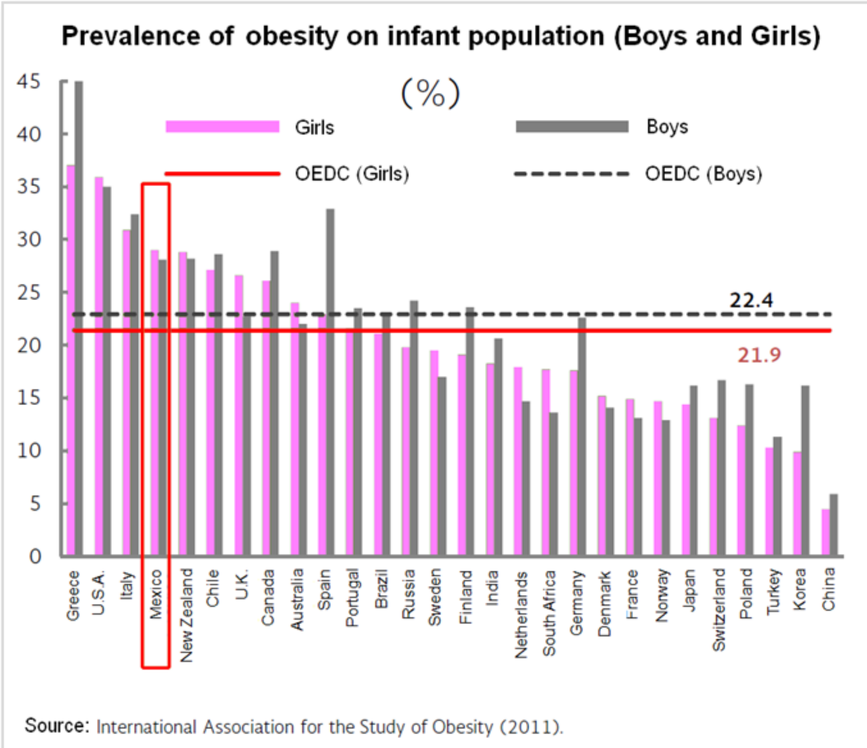


CHART 2. Prevalence of obesity in infant population



In Mexico, there are two coexisting issues that affect public health:

1. A significant increase in overweight and obesity rates
2. Poor nutrition due to (nutritional) deficiencies

The Social and Tax Reform is proposing to add the IETU (Special tax over production and services) tax to all sugary beverages. The proposed tax consists of $1.00 MX Peso per liter. This proposal looks to discourage the intake of empty calories as well as to reduce the incidence of obesity, particularly amongst children. This will improve the quality of life of the population, increase its productivity, and reduce costs related to the treatment of diseases caused by being overweight.

The GOM estimates that the proposal will increase tax revenue by 12 billion MX Pesos (about 900 million USD).

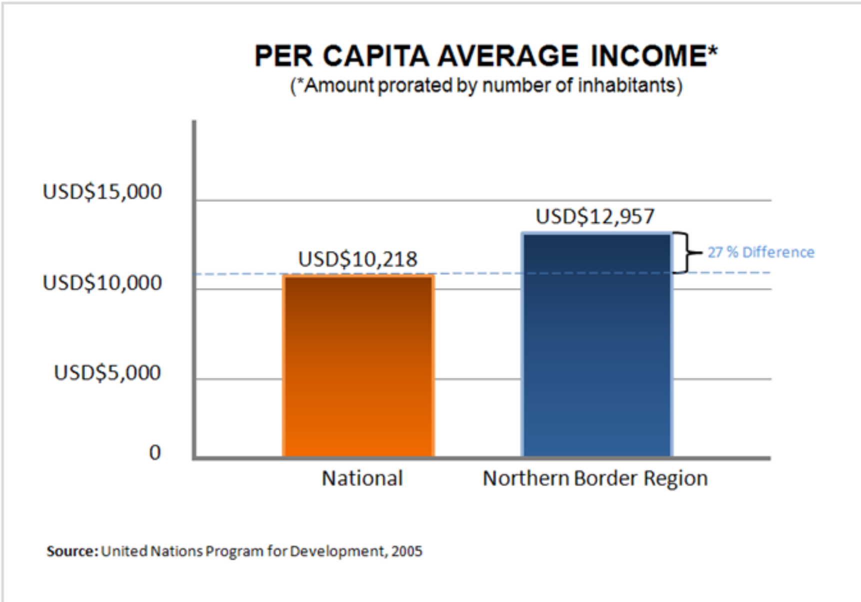
Courtesy Translation: *2014 Economic policy – General Criteria*

2. HARMONIZATION OF VAT (VALUE ADDED TAX) IN ALL MEXICO

All products subject to the value added tax in Mexico will be taxed at 16 percent. This means that the prices for goods sold in the border states, including imported goods, will go up. Any price increase may make some U.S. goods too expensive for lower-income Mexican consumers.

Prior to 2014, operations in the Mexican states along the U.S.-Mexico border were subject to a preferential IVA tax of 11 percent. In its tax reform proposal, the GOM argued that such a tax rate was detrimental to Mexico's economy because it reduced the amount of taxes paid by the part of the Mexican population with the highest income in the country, residents of border states. On average, the population along Mexico's northern border earns 27 more than the national average.

CHART3. Per capita average income in Mexico



According to the GOM, one of the reasons behind the different value added tax levels in Mexico was the isolation of the northern border compared to the rest of the country. However, Mexico's northern border now has some of the best communication infrastructure and transportation in Mexico. Internet access along the border is more prevalent than in the rest of the country as are landlines and cell phone access. Furthermore, border cities are more likely to have airports than cities in the interior of the country with similar populations.

Courtesy Translation: *SAT's IVA Tax description*
Courtesy Translation: *2014 Economic policy – General Criteria*

3. REMAINING ZERO PERCENT TAX TO FOOD AND MEDICINES

The preliminary versions of the tax reform included a tax on food and medicines, which would have increased the consumer price for imported and domestically-produced food. The final version of the tax reform removed the tax on food and medicine.

Given that one of the GOM's objectives with the Social and Tax Reform is to minimize income disparity in Mexico, a zero percent tax rate will remain on foods and medicine. Although the implementation of a tax on foods and medicines would have significantly increased tax revenues equal to about 1 percent of GDP, it was determined that this particular measure would have represented a particularly high cost to households with the lowest incomes in the country. According to the 2012 National Survey of Mexican Income and Expenditures, a tax on food and medicines would have increased taxes for people with the lowest income by 5.6 percent.

4. ELIMINATION OF SPECIAL TREATMENT AND PREFERENTIAL TAX REGIMES

U.S. exporters should be aware that large Mexican companies will likely end up paying more taxes as a result of this section of the reform, which will squeeze the companies' profit margins.

The Social and Tax Reform proposed several modifications to IVA tax exemptions. The reform focused on increasing the tax base by eliminating exemptions deemed the most detrimental to the Mexican economy. Prior to the reform, the multiple preferential tax regimes allowed taxpayers from certain business sectors to avoid income taxes or to obtain generous tax deductions, which greatly reduced tax base. The main preferential tax regimes included the following:

- Fiscal Consolidation Regime

- Manufacturing Companies
- Property Developers
- Simplified Regime
- Mining Regime
- Educational Associations with a Sports Focus

The main change relates to the elimination of the “Fiscal Consolidation Regime”, or holdings. With the changes, special tax deductions are reduced 47 percent, and the number of preferential regimes will drop by 77 percent.

Courtesy Translation: *2014 Economic policy – General Criteria*

5. ESTABLISHMENT OF LIMITS ON PERSONAL TAX EXCEPTIONS AND DEDUCTIONS

As a result of this portion of the tax reform, Mexican consumers will likely have less disposable income to spend on goods and services, including food and beverages.

The individual income tax, or ISR, (there is also a corporate ISR Tax), used to have several exemptions and deductions. Both were mainly used by people with higher incomes; which reduced tax collection. Therefore, it was proposed that a series of reforms that would increase the individual ISR tax base by increasing contributions by people in the highest income bracket, which previously benefitted from about 90 percent of tax exemptions, while less than 1 percent of tax deductions applied to people in the lowest income bracket.
Courtesy Translation*:* *SAT’s description of Individual ISR Tax*

6. TAX ON STOCK AND CAPITAL PROFITS

This portion of the tax may also affect Mexican consumers’ ability to purchase goods and services.

In Mexico, most stock and capital profits used to be tax exempt. The new Social and Tax reforms states that stock and capital profits and sales are now subject to a 10 percent ISR tax, which also applies to foreign investors even if they do not live in Mexico.

Courtesy Translation: *SAT’s description of tax on stock and capital profits*

7. ELIMINATION OF IETU (SPECIAL TAX ON PRODUCTION AND SERVICES), IDE (CASH DEPOSIT TAX) AND NEW ISR (REVENUE TAX) LAW

This section was overruled in the final version of the reform and will therefore not impact U.S. exports.

The former tax structure was based on three taxes: ISR, IETU and IDE. The interaction amongst those three components of the revenue system was high complex and resulted in high operating and control costs. The new Social and Tax reform created a new ISR tax law and eliminated the IETU and IDE taxes, which should facilitate tax calculation and payment.

Courtesy Translation: *2014 Economic policy – General Criteria*

8. CHANGES TO THE CUSTOMS REGULATION

Changes have been put in place to expedite the import of merchandise:

- Exporting to Mexico now longer has to be done in official establishments, regardless of the volume and nature of the merchandise.

- Companies are now able to conduct their own export processes without the mandatory intervention of a customs broker; provided a designated expediter meets requirements. The requirements for the expediter include: being Mexican citizen, having a work relationship with requesting companies, having at least 3 years of experience, passing a general Customs test, and having a taxpayer ID with no violations.

- Customs brokers will no longer be able to pass along their license to their children.

- Customs brokers' licenses can be voided if they allow other people to use it on their behalf.

- All customs operations will be conducted online (import/export), with electronic documentation, including electronic signatures and digital seals.

- Electronic notifications will be sent in order for companies/brokers/expediters to know the status of their shipments. Only RFC holders (Mexican Tax ID) can subscribe to Custom's electronic notifications.

- Second Customs review is voided in order to expedite trade; inspections will be conducted with non intrusive technology to increase safety.

- Strategic Fiscal Establishments will now be available in all of Mexico to improve logistics and to facilitate trade (upon SAT's approval)

- Temporary import of rail transportation and specialized equipment is now allowed for up to 10 years to assist with the 2013 National Development Plan's creation of new railroads as well as the modernization of current railroads to open to commercial trade.

- Customs trade users will have more services to simplify processes, such as corrections, change of merchandize regimes without prior authorizations, and the ability to regularize merchandise that was temporarily imported even when its import limit is reached.

  There will also be greater cooperation with foreign authorities to reinforce:
  - Information Exchange
  - Security on International Logistics

  In order to avoid:
  - Custom's Infraction Fees
  - Smuggling
  - Access to Prohibited Products
  - Product Origin Confusions
  - Product Under and Over Valuation, Among Other Felonies.

Courtesy Translation: *SAT's description of New Customs Law*
Courtesy Translation: *SAT's Q&A about the new Customs Law*

SUMMARY OF TAX AND SOCIAL REFORM CHANGES
The following section includes a summary of the main elements of the Social and Tax Reform that describe 2013 conditions and current status for 2014:

IVA TAX

2013: 11 percent IVA applied in all Mexico/U.S. border states and the entire Baja Peninsula; 16 percent IVA applied in the rest of Mexico. IVA Exemptions: food, medicines, temporary imports

2014: 16 percent IVA in all of Mexico.

New IVA applications: 16 percent to pet food, (also applies to sale of pets and/or small species), chewing gum, foreign ground transportation, temporary imports (although companies can be reimbursed for taxes on temporary imports).

IEPS TAX

2013: Applicable only to fuels, tobacco, and alcohol.

2014: $1.00 MX Peso per liter IEPS tax applies to flavored beverages, juice concentrates, syrups, essences, and flavor extracts. Tax for concentrated extracts will be calculated based on the liters that can be out of it ($1.00 MX Peso per liter). This tax applies to both imports and domestic production.

8 percent IEPS tax applies to non-basic food products (junk food), defined as food with more than 275 calories in 100 grams. For example: fried snacks, confectionery products, cocoa based products, flans, puddings, candies made of fruits or horticultural products, peanut or hazelnut butter, milk candies, cereal based products, ice cream, and popsicles. This tax applies to both import and production.
EXEPTION: This tax is not applicable to food products that are prepared and provided to customers in a restaurant and/or similar venues, as they don't sell or import products, as they only provide food preparation services.

Up to 9 percent IEPS tax to pesticides, according to toxicity levels (from 3 up to 9 percent).

26.5 percent tax on beer of up to 14° of alcohol, 53 percent tax to beer with over 20° alcohol.

Green Taxes: This tax applies to the sale, production, and import of a product. These measures have been taken to encourage the use of cleaner technologies and to discourage gas emissions. It applies to products such as: propane, butane, gasoline, diesel, petroleum, charcoal and other fossil fuels. The tax rate is calculated by volume of carbon dioxide or carbon content.

REVENUE TAX

2013: Individual and corporate tax: 30 percent.

2014: Individual Tax - 30 percent to income of over 392,841 MX Pesos and up to 750,000 MX Pesos.

32 percent tax to income of over 750,000 MX Pesos and up to 1,000,000 MX Pesos.

34 percent tax to income of over 1,000,000 MX Pesos and up to 3,000,000 MX Pesos.

35 percent tax to income of over 3,000,000 MX Pesos.

IETU TAX

2013: 16.5 percent tax to be applied in 2008, 17 percent tax to be applied in 2009, and 17.5 percent tax to be applied beyond 2010.

2014: Overruled.

IDE TAX

2013: Applicable to all cash deposits that exceed $15,000 MX Pesos (about USD $1,175); 3 percent tax is applied to amount exceeding $15,000 MX Pesos; it also applied when obtaining cashier checks of any amount.

2014: Overruled.

Source: *Economic Package for Fiscal Year 2014*
Source: *Q&A about IEPS tax*
Source: *Main changes on 2014 Tax Reform*
Source: *What you need to know about IEPS*
Source: *Q&Q about IVA tax*

TAX EXEMPT FOOD PRODUCTS

Basic consumption of food products that are considered important to the Mexican population will not be subject to IEPS tax, please see the list below:

A. Wheat products:

1. Wheat flour tortillas, including whole wheat.
2. Wheat-based pasta for soups that do not have spices, condiments of vegetables.
3. Un-sweetened bread such as baguettes, ciabatta bread or similar including leaves of bread.
4. Wheat flour, including whole wheat flour.
5. Wheat based food products, including whole wheat, but with no added sugars.

B. Corn chain products:

1. Corn tortilla, even if toasted.
2. Corn flour.
3. Nixtamal and corn dough.
4. Corn cereal food products without added sugars.

C. Wheat chain products:

1. Cereal based food products for toddlers and infants.
2. Cereal based food products without sugars, including whole grain cereals.
3. Un-sweetened bread, whether whole grain cereal or not, including loaves of bread.

Source: SAT´s list of tax exempt food products: *http://www.sat.gob.mx/sitio_internet/servicios/noticias_boletines/33_26371.html*

CONCLUSION

Mexico is well on its way to becoming a more modern society, with the utilization of sophisticated technology to improve information systems, therefore tax reforms are unlikely to be reversed.

This comprehensive Social and Tax Reform will certainly represent challenges for Mexican business as it will impact their operations with new taxes in fuels and fewer tax deductions. The reform will also have a direct impact on food manufacturers whose products have added sugar, as those products will have a new special tax. Some of those manufacturers are currently considering revising their food formulations to both stay competitive in price and at the same time maintain a positive perception before consumers, who will be looking for the most affordable and healthiest products. This is likely to open new possibitilies for imported substitute ingredients, as well as for food products that are perceived to help people become more nutritious and improve their overall wellbeing, as the population is becoming aware of how eating habits impact health and lifestyle in general.

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